EMBARGOED UNTIL: 11.30AM THURSDAY 15 FEBRUARY 2018

THE FORWARD VIEW – GLOBAL

FEBRUARY 2018

National Australia Bank

Summary – Global upturn to continue despite market turbulence

- Recent shifts in financial market pricing reflect the move toward solid global growth, positive data surprises, upward revisions to forecasts and the balance of risks shifting from deflation and slow growth to higher growth and inflation.
- Low interest rates and very low jobless rates have been a rare combination in the last 40 years – normally rates would be higher in the current environment with the lowest jobless rates in the big advanced economies since the 1970s.
- The outlook is for ongoing global growth driving modest rises in wage and price inflation as well as higher interest rates.

	IMF weights	2012	2013	2014	2015	2016	2017	2018	2019
US	15.5	2.2	1.7	2.6	2.9	1.5	2.3	2.7	2.3
Euro-zone	11.7	-0.8	-0.2	1.4	2.0	1.8	2.5	2.5	2.4
Japan	4.4	1.5	2.0	0.3	1.4	0.9	1.8	1.4	0.9
China	17.7	7.7	7.7	7.3	6.9	6.7	6.9	6.5	6.3
Emerging East Asia	8.0	4.7	4.2	4.1	3.7	3.9	4.4	4.3	4.0
NZ	0.2	2.6	2.2	3.6	3.5	4.0	2.9	2.8	3.0
Total	100.0	3.7	3.4	3.5	3.4	3.2	3.6	3.8	3.6

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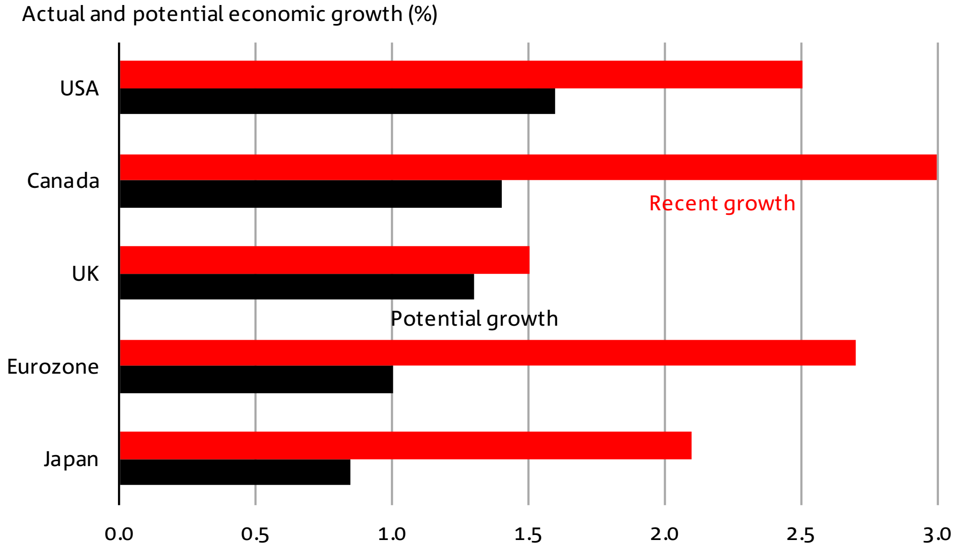
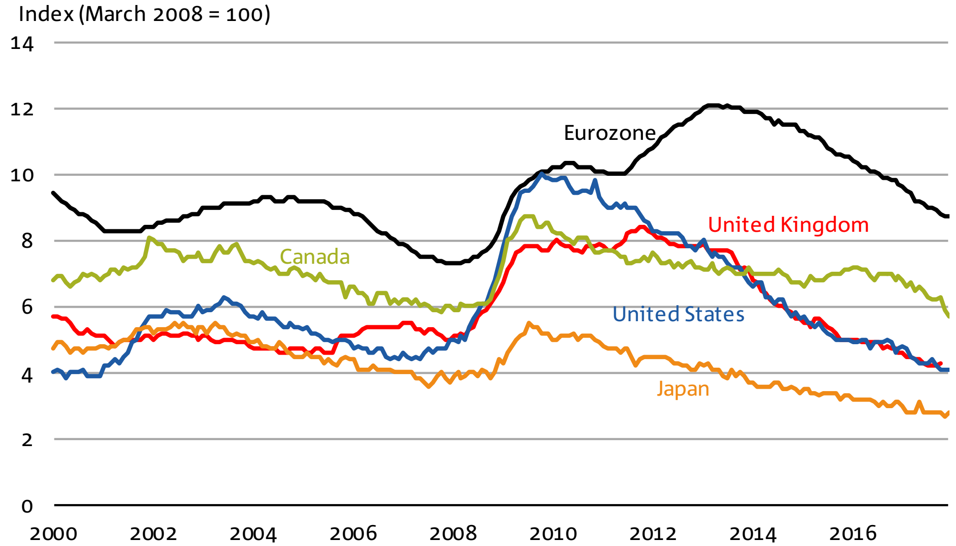
RECENT GROWTH OUTSTRIPS ITS LONG-RUN SUSTAINABLE PACE

Margins of spare capacity dwindling but investment lifts

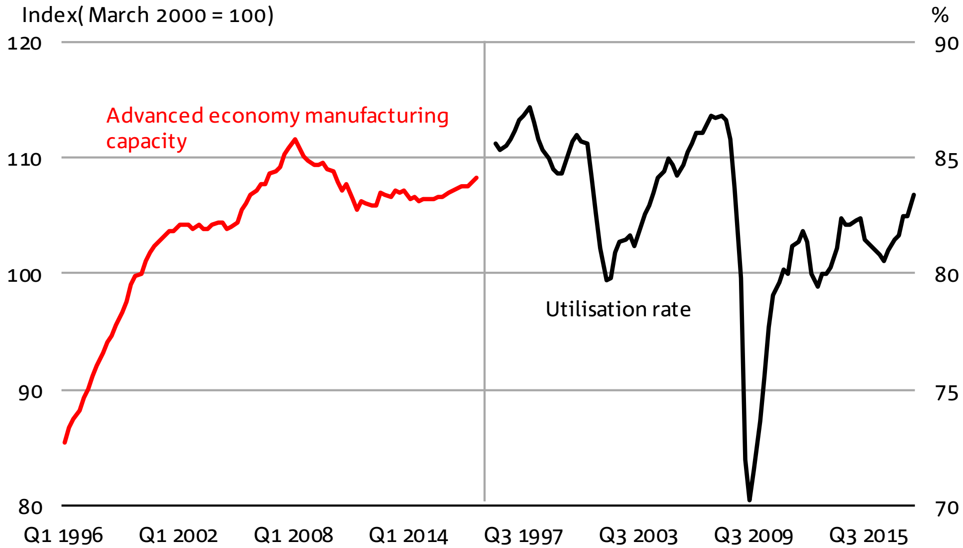
ADVANCED ECONOMY GROWTH ABOVE ITS LONG TERM POTENTIAL



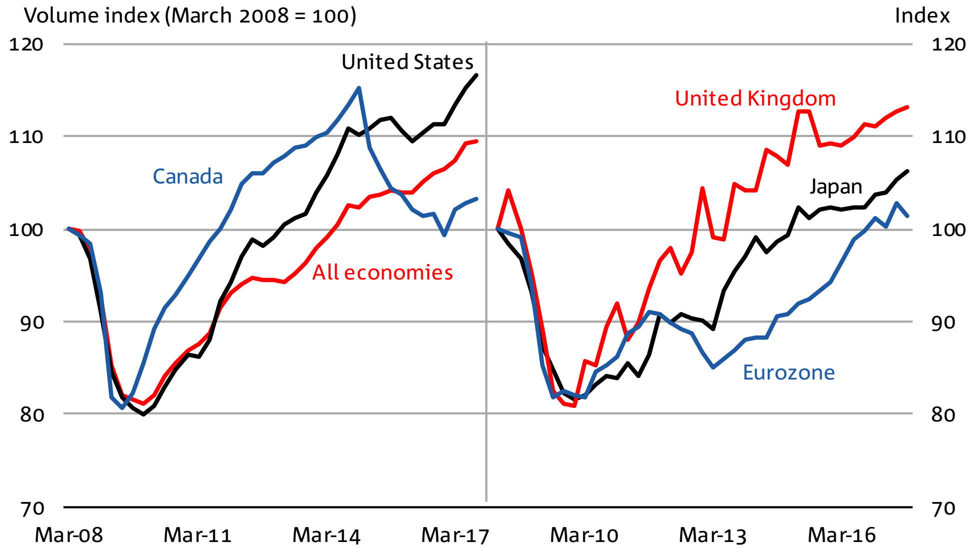
UNEMPLOYMENT TRENDS HAVE CONTINUED TO IMPROVE



INDUSTRIAL CAPACITY UTILISATION HAS PICKED UP...



...STRONGER BUSINESS INVESTMENT SHOULD HELP REBUILD CAPACITY



Sources: CBO, Bank of Canada, Bank of Japan, Norges Bank, Bank of England, Datastream, CEIC, NAB Economics

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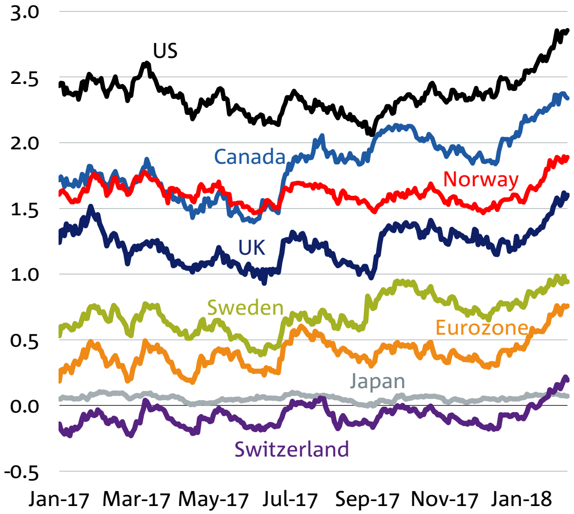
FINANCIAL AND COMMODITY MARKETS

Higher rates and increased volatility should not stop global economic upturn

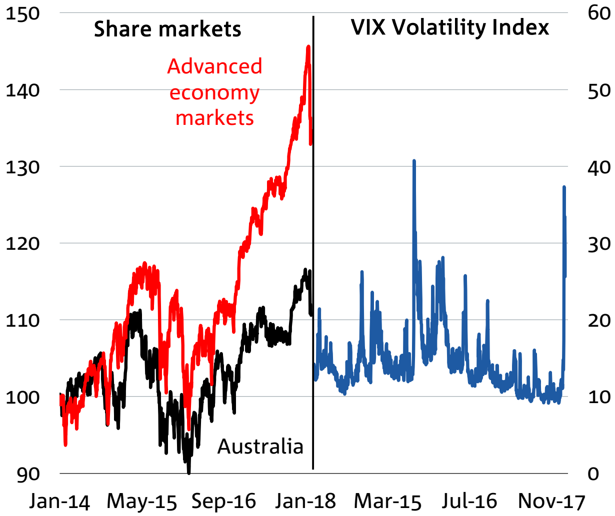
BOND YIELDS TRENDING UP

10 year government bond yields (%)



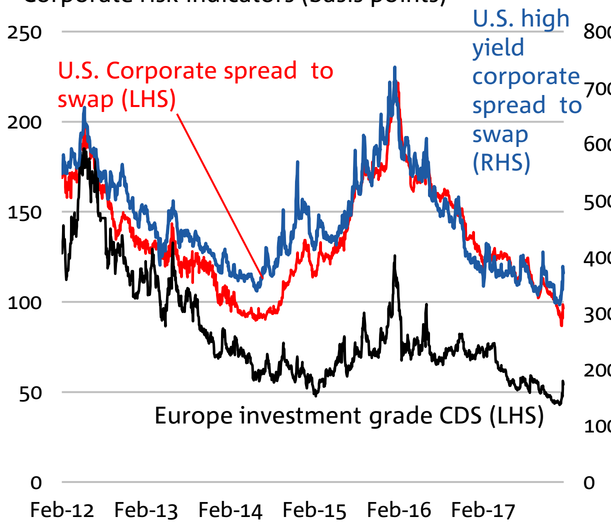
EQUITIES DOWN AS VOLATILITY SURGES

Share markets and volatility indices



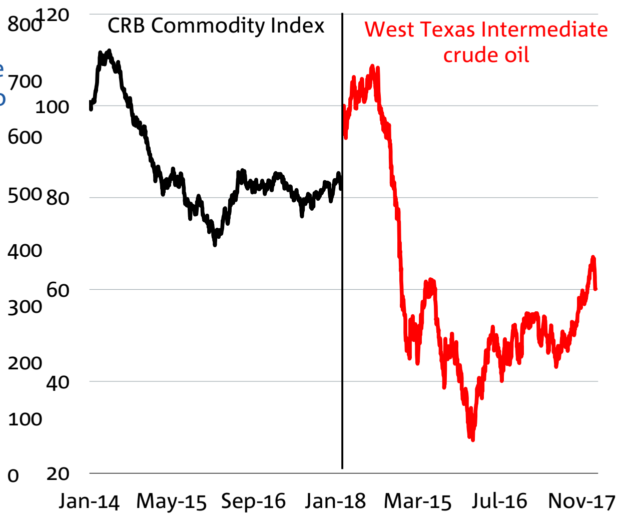
SOME FLOW THROUGH TO SPREADS

Corporate risk indicators (basis points)



COMMODITY PRICES VOLATILE ALSO

Commodity price indices (1 Jan 2014 = 100)



Sources: Datastream, Bloomberg, ECB, Federal Reserve, NAB Economics

- The calm in financial markets for much of 2017 and into early 2018 recently came to an abrupt end with a surge in market volatility and big falls in share prices. The immediate trigger was data showing US wages accelerating but there had been warnings that US shares were over-priced and bond yields set to rise.
- Higher wage inflation increases the chances of a faster pace of interest rate increases and a higher peak in rates. This is because central banks will be more comfortable in withdrawing their post-GFC "emergency" rate and asset buying policies because they are seen to have done their job of buying time to allow the global economy to repair. Markets have tended to price a slower pace of Fed monetary policy tightening than the Fed itself projected but they have also been watching for signs of inflationary pressure as economic growth picks up and the scars of the GFC finally heal.
- Indeed, even prior to the US wages data, long-term bond yields had been rising in many countries as the strength of the economic upturn became increasingly evident and high-profile bond traders had called the end of a 35 year trend of falling US yields. In effect, market concerns are shifting from deflation and overly low wage and price growth toward higher inflation and widening US budget deficits that could propel today's exceptionally low interest rates back to something more historically "normal" for current economic conditions.
- Turbulence has been particularly marked in US share markets because these were already highly priced in the wake of the Trump corporate tax cuts and a strong economic and profit outlook. A long period of low market volatility also led some investors to bet on continued market stability, these trades were left exposed in the wake of the share market reaction to higher bond yields which saw a surge in the VIX measure of market volatility. In contrast, FX markets have been relatively calm and initially there was little flow through to corporate spreads. However, as the turbulence continued, corporate spreads also moved somewhat higher although they still generally remain at modest levels.
- Central banks will be watching these market developments but, so far, they do not seem particularly concerned. As the global economy heals and inflation heads back to target, central banks would be expected to adjust their "emergency" policy to gradually deliver interest rates that are suited (i.e. higher) for more "normal" economic conditions and that, inevitably, has implications across all financial market prices.

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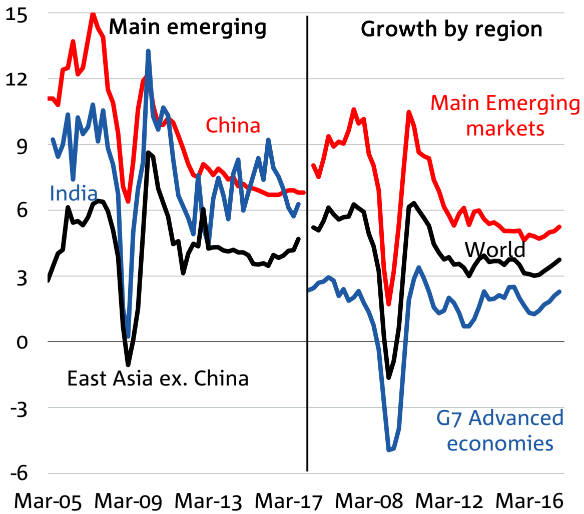
GLOBAL ECONOMIC TRENDS

Synchronised global upturn consolidates above-trend economic growth

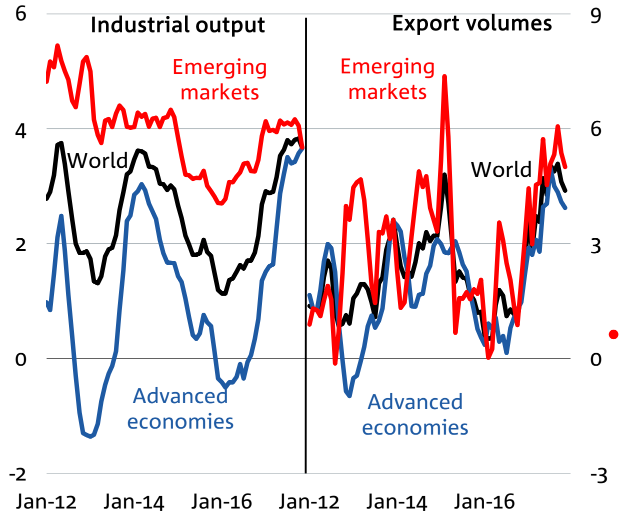
ABOVE TREND GROWTH ARRIVES

Economic growth (% yoy)



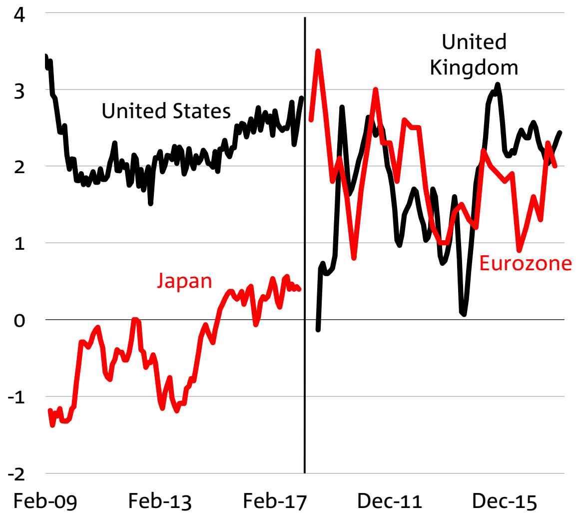
SOLID UPSWING IN GLOBAL ACTIVITY

Global changes in trade and output (% yoy (3mma))



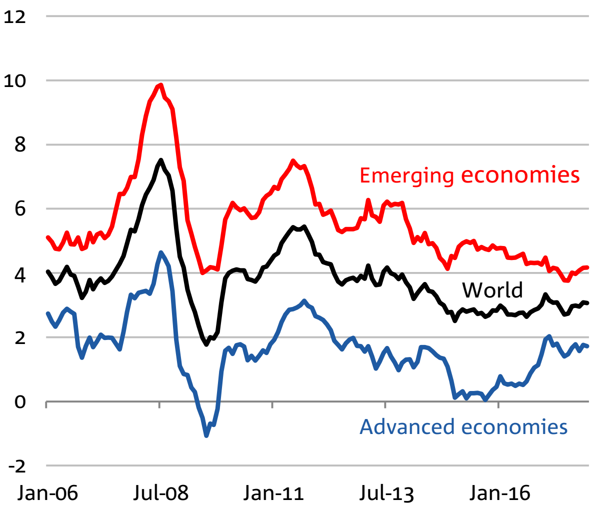
SIGNS OF FASTER WAGE GROWTH

Advanced economy wage growth (% yoy)



AND INFLATION LIFTS SLIGHTLY

Consumer price inflation (yoy%)



- Global economic growth is running above its long-run trend with ongoing solid growth in the big emerging markets coinciding with a lift in the rate of demand expansion in the big advanced economies. Increases in output and spending now outstrip growth in supply capacity across advanced economies that represent a third of the global economy. This is possible as their idle productive resources are brought back into use, reflected in falling jobless rates and increased rates of capacity utilisation. At the same time, emerging market economy growth is robust. China and India (another 25% of the global economy) look set to exceed 6% growth this year and economic expansion has resumed in Russia and Brazil (representing 6% of the global economy) as they move out of recession.

- The most up to date indicators of economic activity show the upturn continuing through the closing months of 2017 and into this year. The momentum of expansion in both industrial output and world trade was being maintained until the end of last year and the business surveys for early 2018 report multi-year highs for recent activity and confidence. Manufacturing surveys are the best for around 7 years and economy-wide measures are the best for 3½ years. Forward-looking survey questions show many firms expect these good conditions to continue.

- As above-trend growth erodes margins of spare capacity, financial markets have become increasingly focussed on the risk that long-quiescent inflationary pressures could return. After years where the focus has been sub-target inflation, deflationary scares and puzzles over why wage growth has been so low, US bond traders have switched to a heightened sensitivity that low jobless rates could see pay growth and inflation move up, taking interest rates with them.

- There has been some evidence of faster wage growth around the advanced economies, including in the US, but it is recent and patchy. Inflation is also just moving back toward target rather than above it. The question is whether the scars of the GFC on the world economy are now healing sufficiently fast that the emergency low rates and asset buying response to the crisis could be destined for the history books faster than the markets originally expected.

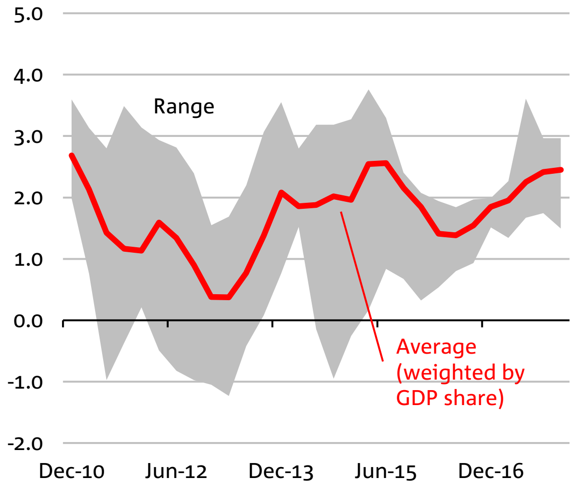
Sources: Datastream, NAB Economics, CPB

ADVANCED ECONOMIES

Growth lifts to over 2% and business surveys are still optimistic

AVERAGE GROWTH LIFTS TO 2%+....

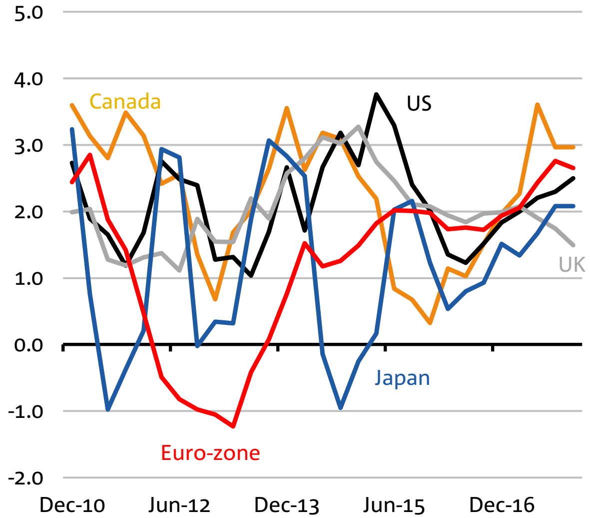
US, Japan, Euro, Canada & UK GDP growth* (yoy%)



* For Canada & Japan; Dec '17 set equal to previous qtr

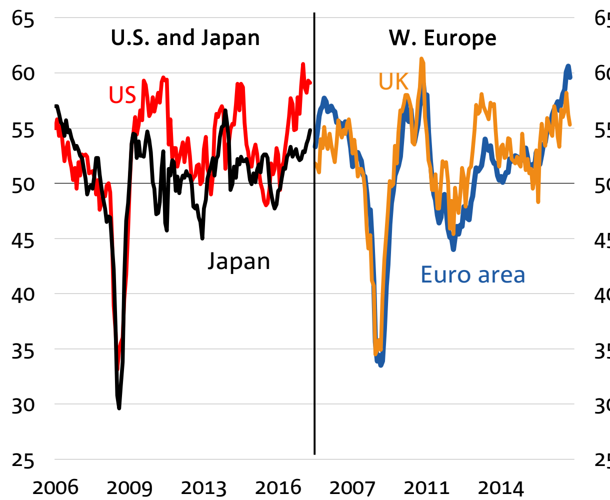
AND CONVERGES ACROSS ECONOMIES

Major advanced economy growth rates (yoy%)



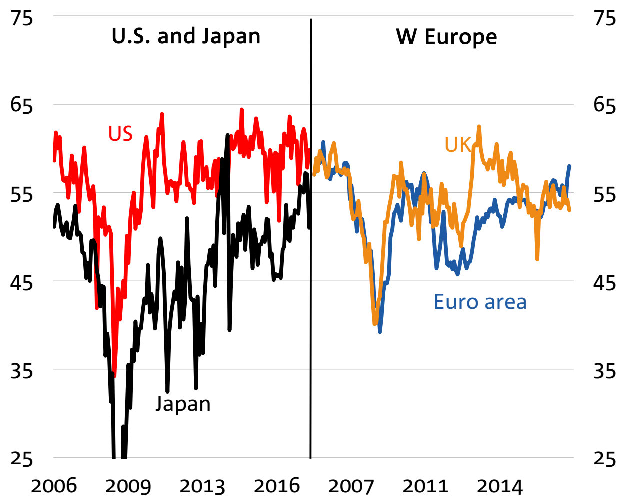
INDUSTRY SURVEYS VERY OPTIMISTIC

Advanced Economy Manufacturing PMIs (50=Breakeven)



SERVICE PROVIDERS OPTIMISTIC TOO

Advanced Economy Services PMIs (50 = Breakeven level)



Sources: Datastream, Markit, ISM, NAB Economics

- The pace of economic growth in the big advanced economies has accelerated to around 2¼% yoy in the latter half of last year, well above the 1¼% yoy rate recorded in mid-2016. The upturn has also become much more synchronised with formerly slowly growing areas like Japan and the Euro-zone moving above the 2% growth threshold that had already been passed by the US and Canada in this upturn.
- While annual economic growth of 2 to 3% in the big advanced economies falls short of the 5%+ plus seen in the emerging market economies and the 3% averaged in Australia since 2000, it is a pretty good outcome for these economies. The last time their growth exceeded 2½% was in the recovery from the deep recession that followed the GFC and their average growth since 2000 is only 1.6%. Furthermore, estimates of the rate of sustainable growth in the supply potential of these economies are generally both low and well under recent increases in output - so the pace of expansion can only be maintained by drawing on dwindling margins of spare productive capacity left standing idle in earlier years of weak outcomes.
- The key to lifting long-term economic performance is now to lift capacity by structural improvements that increase investment, improve labour productivity, encourage greater participation in the labour force, boost the skills and human capital of the workforce and support research and development. Recent history has not been positive in several of these areas so there is room for improvement after years of disappointing growth in labour productivity, flat to falling industrial capacity, side-lined prime age people outside employment, unstable precarious jobs offering little training or skills development and, finally, the legacy of low investment post-GFC.
- Pursuing avenues to lift potential growth is increasingly important because the latest surveys do not show any sign that demand growth is about to slow. Markets should start to be concerned that a squeeze on productive resources in some big advanced economies could emerge sooner than previously thought as tax and spending policy fuel further demand expansion in the US and estimates of spare capacity and potential growth are revised downwards elsewhere. The US jobless rate is around 4%, Japan's is under 3% and across the G7 advanced economies it has fallen to around 5%, low by the standards of the last 30 years.

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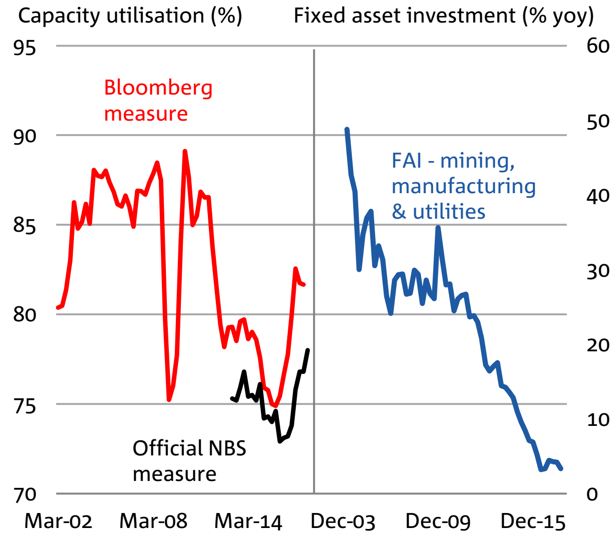
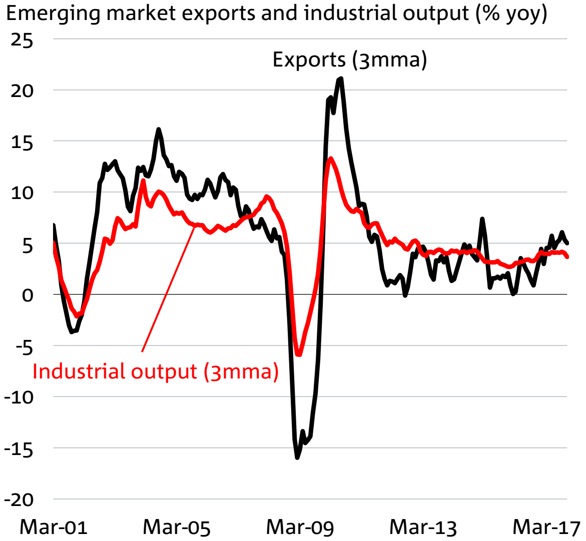
EMERGING MARKET ECONOMIES (EMES)

Mixed trends in EMEs, with softer industrial growth in Asia

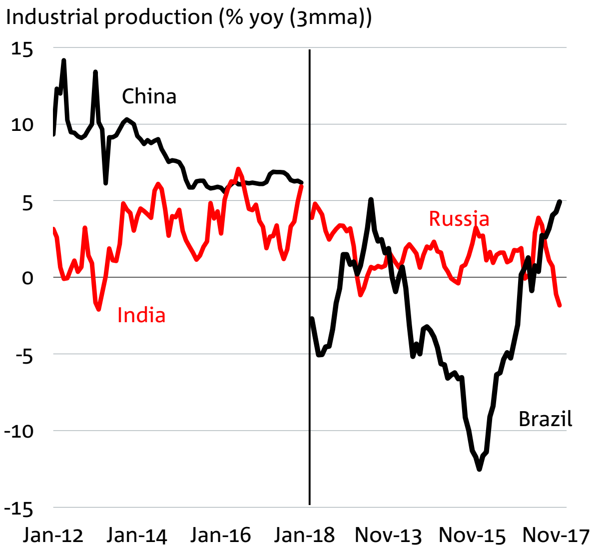
CHINA'S UTILISATION RISING



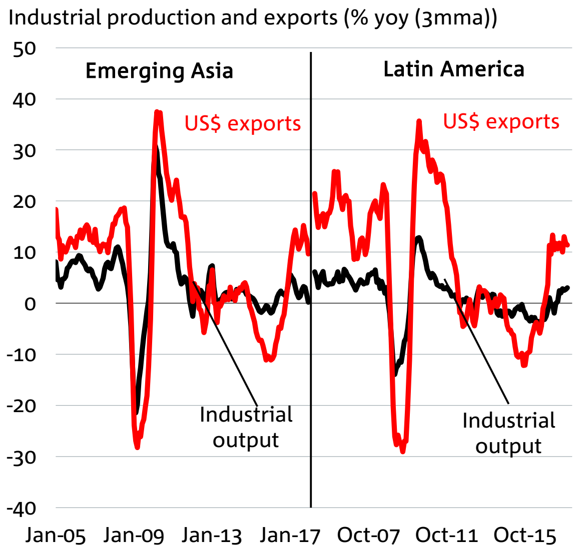
EME EXPORTS UP ON STRONG GLOBE



DIFFERING TRENDS IN MAJOR EMES



OUTPUT IN ASIA WEAKER IN Q4



Sources: Datastream, Bloomberg, CEIC, NAB Economics

- As has been the case in advanced economies, capacity utilisation in China has been increasing. That said, industrial trends differ – with a slowdown in investment in industrial sectors. In part, rising utilisation in China reflects efforts to address excess production capacity across a range of sectors (including steel, cement, glass and chemicals), along with improved demand trends in China during 2017. The former suggests that there is limited growth potential from business investment in China's industrial sector.

- China's economy grew by 6.9% in 2017 (compared with 6.7% in 2016), the first acceleration in growth since 2010 and well ahead of the government's growth target. In Q4, China's services sector grew by 8.5% yoy (up from 8.0% previously), while secondary industries (manufacturing and construction) slowed to 5.6% yoy (from 6.1% in Q3). This suggests that China's gradual transition away from heavy industrial led growth towards consumption is continuing.

- More broadly, emerging market industrial production has continued to grow robustly – having accelerated to around 4% yoy in early 2017 (from recent lows of 2¾% in late 2015 and early 2016) and remaining around these levels across most of the year. The CPB measure dipped in November – but it is too early to tell if this was a one-off decline or if it represents the start of a slowing trend.

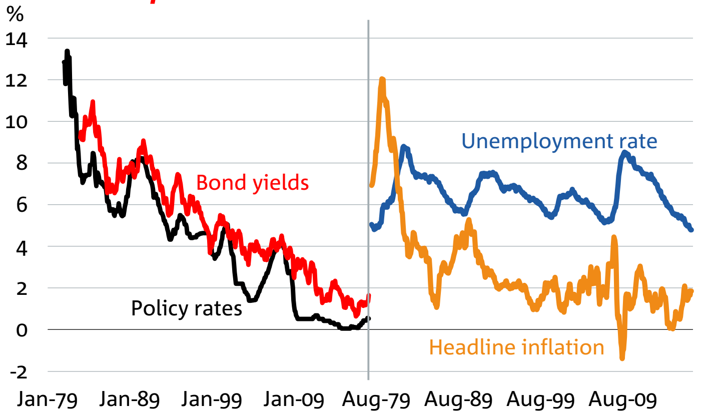
- Stronger export volumes have contributed to the improved industrial conditions in emerging markets – reflecting the increased demand generated by the general upturn in the global economy. Volume growth was non-existent in February 2016, but accelerated to around 5% yoy in November 2017.

- That said, industrial trends differ considerably across emerging economies. While China's growth has remained stable and the most recent data for both India and Brazil are stronger, Russia's industrial output was surprisingly weak in late 2017. Similarly, our measure of industrial production in emerging Asia (which excludes both China and India) has slowed considerably since September – with a marked decrease in the Philippines in Q4.

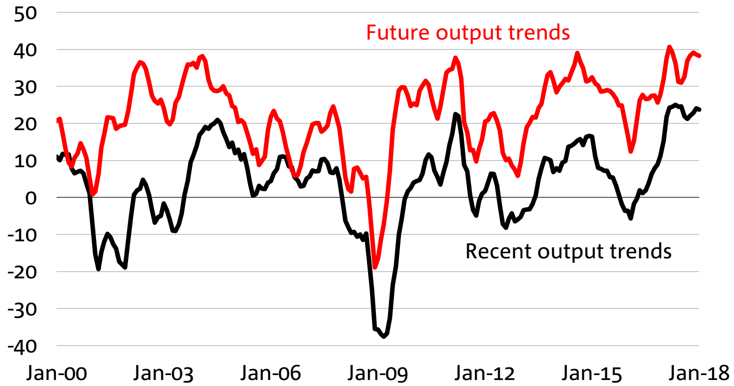
GLOBAL FORECASTS, POLICIES AND RISKS

Financial markets focus more on inflation risks from solid global upturn

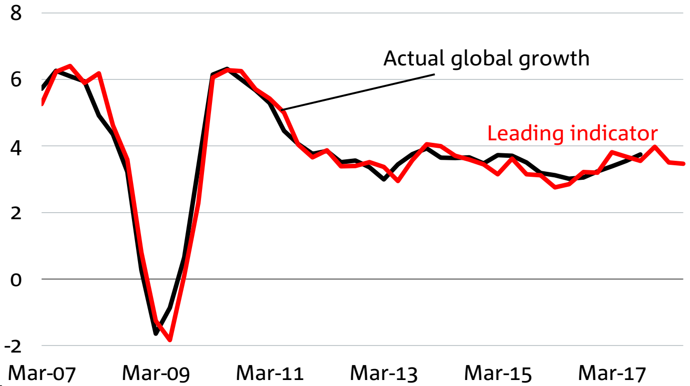
HOW FAR/SOON DO RATES MOVE TO NORMAL



Business surveys (US, UK, Germany & France) (Index)



Actual global growth and leading indicator (% yoy)



- We think recent volatility in global financial markets reflects investors concluding that a solid global economic upturn has shifted the direction of risk away from price deflation and low growth and towards positive surprises in the economic data and the emergence of higher inflation. Unemployment in the big advanced economies has fallen to levels last seen in the 1970s but key interest rates are around historic lows. This combination of tightening constraints on supply and very low rates is only possible because up till now inflation has been subdued and wages surprisingly unresponsive to tighter job markets. Markets may turn out to have over-reacted to one month's US wage number, but recent price action is symptomatic of sensitised investors watching for signs of higher inflation and they are not going to stop looking. Consequently we can expect further volatility as the data arrives.
- We think the global upturn will continue with above-trend growth through 2018 and 2019 as central banks are cautious and gradual in tightening their monetary policy and governments give low priority to budget repair or curbing high debt loads. If the estimates of growth in supply potential and spare capacity are right, and measuring these is not an exact science, current rates of demand growth will increasingly hit supply constraints in the next few years. That period will deliver the acid test of whether prices and wages behave the way they usually have – with tighter markets delivering more pricing power to business and bargaining power to employees that shows up in higher inflation.
- Our expectation is that central banks will gradually lift their policy rates and bond markets will increase yields as wage and price inflation increases – but although these rate rises will curb the rate of economic growth in the short run, they should ensure a more sustainable upturn over the long haul as demand growth is not allowed to overheat. The bottom line is that the latest bout of financial market turbulence has not changed the outlook which is still a positive one of sustained economic growth.

	2012	2013	2014	2015	2016	2017	2018	2019
US	2.2	1.7	2.6	2.9	1.5	2.3	2.7	2.3
Euro-zone	-0.8	-0.2	1.4	2.0	1.8	2.5	2.5	2.4
Japan	1.5	2.0	0.3	1.4	0.9	1.8	1.4	0.9
UK	1.5	2.1	3.1	2.3	1.9	1.8	1.8	1.5
Canada	1.7	2.5	2.6	0.9	1.5	3.0	2.1	1.8
China	7.7	7.7	7.3	6.9	6.7	6.9	6.5	6.3
India	7.3	6.1	7.0	7.5	7.9	6.4	7.1	7.3
Latin America	2.7	2.5	0.9	0.1	-0.9	1.2	2.6	2.9
Emerging East Asia	4.7	4.2	4.1	3.7	3.9	4.4	4.3	4.0
NZ	2.6	2.2	3.6	3.5	4.0	2.9	2.8	3.0
Total	3.7	3.4	3.5	3.4	3.2	3.6	3.8	3.6

Sources: Datastream, Bloomberg , NAB Economics

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